UNIT – 4: FISCAL POLICY

Introduction

- Fiscal policy is the deliberate policy of the government under which it uses the instruments of taxation, public expenditure and public borrowing to influence both the pattern of economic activity and level of aggregate demand, output and employment.
- Fiscal policy is in the nature of a demand-side policy.
- An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

The classical economists held the belief that the government should not intervene in the economy because the market mechanism makes the economy self-adjusting and keeps the economy at or near the natural level of real GDP at all times. The government should have a balanced budget and any deliberate fiscal policies are unnecessary.

The Depression resulted in very low aggregate demand along with high levels of unemployment. The classical economics could not provide any solution to this problem. In 1936, the British economist John Maynard Keynes in his book 'The General Theory of Employment, Interest, and Money' advocated increase in government spending to combat the recessionary forces in the economy and to solve the problem of unemployment. In recent times, especially after being threatened by the global financial crisis and recession, many countries have preferred to have a more active fiscal policy.

Objectives of Fiscal Policy

Since nations differ in numerous aspects, the objectives of fiscal policy also may vary from country to country. However, the most common objectives of fiscal policy are:

- Achievement and maintenance of full employment,
- Maintenance of price stability, - Moderate Inflation.
- Acceleration of the rate of economic development, and
- Equitable distribution of income and wealth

The importance as well as order of priority of these objectives may vary from country to country and from time to time. For instance,

📌 while stability and equality may be the priorities of developed nations,

📌 economic growth, employment and equity may get higher priority in developing countries.

- Governments may directly as well as indirectly influence the way resources are used in an economy. Fiscal policy is a powerful tool for managing the economy because of its ability to influence the total amount of output produced viz. gross domestic product.
- The ability of fiscal policy to influence output by affecting aggregate demand makes it a potential instrument for stabilization of the economy.

$$\boxed{AD/GDP = C + I + \overset{\text{Direct}}{G} + NX}$$

- The governments can influence the level of economic activity (GDP) by directly controlling G (government expenditure i.e purchases of goods and services by the government) and indirectly influencing C (private consumption), I (investment), and NX (net exports or exports minus imports), through changes in taxes, transfer payments and public expenditure.

1. Expansionary - Job contraction होता है
Hume Expansion chahiye

Types of Fiscal Policy

Contra cyclical fiscal policy or fiscal policy measures to correct different problems created by business-cycle instability are of two basic types namely, expansionary fiscal policy and contractionary fiscal policy.

📝Expansionary Fiscal Policy

boost

◾ Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of a business cycle or when there is an anticipation of a business cycle contraction.

◾ A recession is said to occur when the overall economic activity declines, or in other words, when the economy 'contracts'. A 'demand-deficient' recession sets in with a period of falling real GDP, low aggregate demand and reduced consumer spending and rising unemployment. To combat (Fight) such a slump (fall) in overall economic activity, the government can resort to expansionary fiscal policies.

📌We may technically refer to this as a policy measure to close a 'recessionary gap'. AD<AS (output)
How does the government achieve this?

Income Tax GST

🎯The government may cut all types of taxes, direct and indirect, leaving the taxpayers with extra money to spend so that there is more purchasing power and more demand for goods and services. Consequently aggregate demand, output and employment increase.

🎯An increase in government expenditure will pump money into the economy and increase aggregate demand. This in turn will increase output and employment.

🎯A combination of increase in government spending and decrease in personal income taxes and/or business taxes.

E > R

◾ While resorting to expansionary fiscal policy, the government may run into budget deficits because tax cuts reduce government income and the government expenditures exceed tax revenues in a given year.

Jab Expansion chal Raha hogo → AD > AS → Inflation ↑ → Price ↑

Contractionary fiscal policy

■ Contractionary fiscal policy is designed to restrain (Control) the levels of economic activity of the economy during an inflationary phase or when there is anticipation of a business-cycle expansion which is likely to induce inflation.

■ Contractionary fiscal policy refers to the deliberate policy of government applied to curtail (decrease) aggregate demand and consequently the level of economic activity.

📌In other words, it is fiscal policy aimed at eliminating an 'inflationary gap'. AD > AS

■ If the state of the economy is such that its growth rate is extraordinarily high causing inflation and asset bubbles, contractionary fiscal policy can be used to confine it into sustainable levels.

Contractionary fiscal policy works through:

🎯Decrease in government spending: With decrease in government spending, the total amount of money available in the economy is reduced which in turn has the effect of reducing the aggregate demand.

🎯Increase in personal income taxes and/or business taxes: An increase in personal income taxes reduces disposable incomes leading to fall in consumption spending and aggregate demand. An increase in taxes on business profits reduces the surpluses available to businesses, and as a result, firms' investments shrink causing aggregate demand to fall. Increased taxes also dampen the prospects of profits of potential entrants who will respond by holding back fresh investments.

🎯A combination of decrease in government spending and increase in personal income taxes and/or business taxes.

↓E > R↑ Deficit ↑

Deficit ↓ Surplus R > E

■ Contractionary fiscal policy should ideally lead to a smaller government budget deficit or a larger budget surplus.

Revenue ↑ Exp ↓

INFLATION

fiscal policy aims at controlling excessive aggregate spending

↓

Contractionary Fiscal policy

DEFLATION

fiscal policy aims to increase effective demand by boosting aggregate spending.

↓

Expansionary Fiscal policy

THE INSTRUMENTS OF FISCAL POLICY

1) Government Expenditure as an Instrument of Fiscal Policy

- Public expenditure includes governments' expenditure towards consumption, Rev. Exp investment, and transfer payments. Cap Exp

- Fiscal policy relates to decisions that determine whether the government's expenditure is more or less than what it receives. A reduction or increase in it may result in significant variations in the country's total income. As such, public expenditure can be instrumental in adjusting consumption and investment to achieve full employment.

- Public expenditures are income generating and include all types of government expenditure such as capital expenditure on public works, relief expenditures, subsidy payments of various types, transfer payments and other social security benefits

Exp ↑ — Requires Paisa — But Taxes can't be ↑ / Borrowing ↑ / Printing ↑

Government expenditures include:

- current expenditures to meet the day to day running of the government,
- capital expenditures which are in the form of investments made by the government in capital equipments and infrastructure, and
- transfer payments i.e. government spending which does not contribute to GDP because income is only transferred from one group of people to another without any direct contribution from the receivers.

- During a recession, it may initiate a fresh wave of public works, such as construction of roads, irrigation facilities, sanitary works, ports, electrification of new areas etc.
- Government expenditure involves employment of labour as well as purchase of multitude of goods and services.
- These expenditures directly generate incomes to labour and suppliers of materials and services.
- Apart from the direct effect, there is also indirect effect in the form of working of multiplier. The incomes generated are spent on purchase of consumer goods. The extent of spending by people depends on their marginal propensity to consume (MPC). There is generally surplus capacity in consumer goods industries during recession and an increase in demand for various goods leads to expansion in production in those industries as well.

A relevant question here is; from where will the government find resources to increase its expenditure?

👉We know that if government resorts to increase in taxes, it is self- defeating as increased taxes will reduce the disposable incomes and therefore aggregate demand. The government should in such cases go for a deficit budget which may be financed either through borrowing or through monetization (creation of additional money to finance expenditure).

Additionally, a programme of public investment will strengthen the general confidence of businessmen and consequently their willingness to invest.

AD > AS

Public expenditure is also used as a policy instrument to reduce the severity of inflation and to bring down the prices. This is done by reducing government expenditure when there is a fear of inflationary rise in prices. Reduced incomes on account of decreased public spending help eliminate excess aggregate demand.

2) Taxes as an Instrument of Fiscal Policy

- Tax as an instrument of fiscal policy consists of changes in government revenues or in rates of taxes aimed at encouraging or restricting private expenditures on consumption and investment.

Tax↓ Tax↑

- Taxes determine the size of disposable income in the hands of the general public which in turn determines aggregate demand and possible inflationary and deflationary gaps.
- The structure of tax rates is varied in the context of the overall economic conditions prevailing in an economy:

📝During recession and depression, the tax policy is framed to encourage private consumption and investment. A general reduction in income taxes leaves higher disposable incomes with people inducing higher consumption. Low corporate taxes increase the prospects of profits for business and promote further investment. The extent of tax reduction and /or increase in government spending required depends on the size of the recessionary gap and the magnitude of the multiplier.

MPC ↑
Inv. Multiplier ↑

📝During inflation, new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes and to wipe off the surplus purchasing power. However, excessive taxation usually stifles new investments and therefore the government has to be cautious about a policy of tax increase.

3) Public Debt as an Instrument of Fiscal Policy

- Public debt may be internal or external; when the government borrows from its own people in the country, it is called internal debt.
- On the other hand, when the government borrows from outside sources, the debt is called external debt.
- Public debt takes two forms namely, market loans and small savings.

📝In the case of market loans, the government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets. For financing capital projects, long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued.

📝The small savings represent public borrowings, which are not negotiable and are not bought and sold in the market. In India, various types of schemes are introduced for mobilising small savings e.g., National Savings Certificates, National Development Certificates, etc.

NSC

📌Borrowing from the public through the sale of bonds and securities curtails the aggregate demand in the economy.

📌Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

4) Budget as an Instrument of Fiscal Policy

■ The budget is simply a statement of revenues earned from taxes and other sources and expenditures made by a nation's government in a year. The net effect of a budget on aggregate demand depends on the government's budget balance.

A government's budget can either be balanced, surplus or deficit.

📝A **balanced budget** results when expenditures in a year equal its tax revenues for that year. Such a budget will have no net effect on aggregate demand since the leakages (Tax) from the system in the form of taxes collected are equal to the injections (Inv./Exp.) in the form of expenditures made.

R>E

📝A **budget surplus** that occurs when the government collects more than what it spends, though sounds like a highly attractive one, has in fact a negative net effect on aggregate demand since leakages exceed injections.

Taxes > Exp

📝A **budget deficit** wherein the government expenditure in a year is greater than the tax revenue it collects has a positive net effect on aggregate demand since total injections exceed leakages from the system.

E>T

📌While a budget surplus reduces national debt, a budget deficit will add to the national debt.

Tax Rev > Exp E > R

AD > AS
High Inflation

Fiscal Policy for Long-run Economic Growth

We know that economic growth is indispensable for sustainable development and favourable social outcomes. The demand-side fiscal policies unaccompanied by policies to stimulate aggregate supply cannot produce long-run economic growth.

Fiscal policy influence economic growth through its effects on the incentives faced by individuals and firms. For example;

- Fiscal policies such as those involving infrastructure spending generally have positive supply-side effects. When government supports building a modern infrastructure, the private sector is provided with the requisite overheads (Support | Services) it needs.
- Government provision of public goods such as education, healthcare, nutrition, research and development etc. provide momentum for long-run economic growth through human capital formation. Increase in human capital makes physical capital more productive.
- Taxes can have either positive or negative impact on economic growth depending on whether it encourages or discourages saving and investment.
- A well designed tax policy that rewards innovation and entrepreneurship, without discouraging incentives will promote private businesses who wish to invest and thereby help the economy grow. For example, an increase in corporate taxes to raise extra revenue may have adverse consequences on incentives and output.
- Tax and spending policies (e.g. subsidies) can be effectively used to correct market failures resulting from externalities.
- Increase in environment taxes increase the cost of firms and reduce their output
- Subsidies on inputs and support prices to producers (e.g. farmers) generate higher output.

Fiscal Policy for Reduction in Inequalities of Income and Wealth

Many developed and developing economies are facing the challenge of rising inequality in incomes and opportunities. Fiscal policy is a chief instrument available for governments to influence income distribution and plays a significant role in reducing inequality and achieving equity and social justice.

The distribution of income in the society is influenced by fiscal policy both directly and indirectly. We shall see a few such measures as to how each of these can be manipulated to achieve desired distributional effects.

- A progressive direct tax system ensures that those who have greater ability to pay contribute more towards defraying (to pay) the expenses of government and that the tax burden is distributed fairly among the population.
- Indirect taxes can be differential: for example, the commodities which are primarily consumed by the richer income group, such as luxuries, are taxed heavily and the commodities the expenditure on which forms a larger proportion of the income of the lower income group, such as necessities, are taxed light or not taxed at all.

- A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society. This is done through spending programmes targeted at welfare measures for the disadvantaged, such as

(i) poverty alleviation programmes

(ii) free or subsidized medical care, education, housing, essential commodities etc. to improve the quality of living of the poor

(iii) infrastructure provision on a selective basis (e.g. rural roads, water supply for tribal area)

(iv) various social security schemes under which people are entitled to old-age pensions, unemployment relief, sickness allowance etc.

(v) subsidized production of products of mass consumption

(vi) public production and/ or grant of subsidies to ensure sufficient supply of essential goods, and

(vii) strengthening of human capital for enhancing employability etc.

- Choice of a progressive tax system with high marginal taxes may act as a strong deterrent (discourage) to work, save and invest. Therefore, the tax structure has to be carefully framed to mitigate possible adverse impacts on production and efficiency.
- Additionally, a highly redistributive fiscal policy with excessively generous social programs can reduce incentives to work and save.

Limitations of Fiscal Policy

- One of the biggest problems with using planned fiscal policy to counteract fluctuations is the different types of lags involved in fiscal-policy action. There are significant lags namely:

👉**Recognition lag**: The economy is a complex phenomenon and the state of the macro economic variables is usually not easily comprehensible (understood). There is difficulty in collecting accurate and timely data. There may be delay on the part of the government to recognize the need for a policy change.

👉**Decision lag**: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to make a decision on the most appropriate policy.

👉**Implementation lag**: even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them on account of bureaucracy. This is specially so under a democratic set up.

👉**Impact lag**: impact lag occurs when the outcomes of a policy are not visible for some time.

- Fiscal policy changes may at times be badly timed due to the various lags so that it is highly possible that an expansionary policy is initiated when the economy is already on a path of recovery and vice versa.

■ There are difficulties in instantly changing governments' spending and taxation policies.

■ It is practically difficult to reduce government spending on various items such as defence and social security as well as on huge capital projects which are already midway.

■ Public works cannot be adjusted easily along with movements of the trade cycle because many huge projects such as highways and dams have long gestation period. Besides, some urgent public projects cannot be postponed for reasons of expenditure cut to correct fluctuations caused by business cycles.

■ Supply-side economists are of the opinion that certain fiscal measures will cause disincentives. For example, increase in profits tax may adversely affect the incentives of firms to invest and an increase in social security benefits may adversely affect incentives to work and save.

$E > R \rightarrow Emp\uparrow \rightarrow Income\uparrow \rightarrow AD\uparrow$ but $AS\uparrow\times \rightarrow AD > AS \rightarrow Prices\uparrow$

■ Deficit financing increases the purchasing power people. The production of goods and services, especially in under developed countries may not catch up simultaneously to meet the increased demand. This will result in prices spiraling beyond control.

■ Increase ~~is~~ in government borrowing creates perpetual burden on even future generations as debts have to be repaid. If the economy lags behind in productive utilization of borrowed money, sufficient surpluses will not be generated for servicing debts. External debt burden has been a constant problem for India and many developing countries.

■ If governments compete with the private sector to borrow money for spending, it is likely that interest rates will go up, and firms' willingness to invest may be reduced. Individuals too may be reluctant to borrow and spend and the desired increase in aggregate demand may not be realised.

Crowding Out

- Some economists are of the opinion that government spending would sometimes substitute private spending and when this happens the impact of government spending on aggregate demand would be smaller than what it should be. In such cases, fiscal policy may become ineffective.

- Substantial government borrowing in the credit market tends to reduce the amount of funds available and pushes the interest rates up. Higher interest rates slow down business investment expenditures and consumption expenditures that are sensitive to interest rates. An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy. In other words, when spending by government in an economy replaces private spending, the latter is said to be crowded out. 👉As a result, the effectiveness of expansionary fiscal policy in stimulating aggregate demand will be diminished to a great extent. This may also possibly reduce the economy's prospects of long-run economic growth.

- However, during deep recessions, crowding-out is less likely to happen as private sector investment is already minimal and therefore there is only insignificant private spending to crowd out. Moreover, during a recession phase the government would be able to borrow from the market without increasing interest rates.

Govt Exp ↑ → Govt Borrowing ↑ → Demand for Loans ↑ → Int Rate ↑ [D>S]

Govt Exp ↑ → AD for Goods & Services ↑ → Private Business Sector wants to Inc Investment → Int Rate ↑

Int Rate ↑ → Discourage, Disincentive

Chapter over :)